DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 00-0445
Indiana Corporate Income Tax
For the Tax Years 1994 through 1998

NOTICE: Under IC 4-22-2-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Exclusion of Taxpayer's Subsidiary from Taxpayer's Consolidated Adjusted Gross Income Tax Return – Adjusted Gross Income Tax.

Authorities: IC 6-3-2-2(l); IC 6-3-2-2(m); 45 IAC 3.1-1-62; 45 IAC 3.1-1-111.

Taxpayer protests the audit's determination that its out-of-state subsidiary should be excluded from the taxpayer's consolidated adjusted gross income tax return. The exclusion of the subsidiary had the effect of increasing the taxpayer's corporate income tax liabilities. The taxpayer argues that the exclusion of the subsidiary resulted in an unfair and arbitrary division of taxpayer's income derived from Indiana sources.

II. Resource Recovery System Credit – Gross Income Tax.

Authorities: IC 6-2.1-4-3(a); IC 6-2.1-4-3(b); IC 13-11-2-99(a); IC 13-11-2-205(a).

Taxpayer protests the audit's decision to disallow taxpayer's depreciation deduction for its resource recovery system. The taxpayer's argues that the disallowance was erroneous and that it was entitled to the deduction.

STATEMENT OF FACTS

Taxpayer is a major steel manufacturer operating facilities inside and outside the state. The audit determined that the taxpayer was not entitled to include one of its subsidiaries in its consolidated income tax return. The audit also determined that taxpayer was not entitled to a depreciation credit for its resource recovery system. These decisions resulted in Notices of Proposed Assessment for deficiencies in Indiana corporate income tax. The taxpayer protested the audit's decisions, an administrative hearing was held, and this Letter of Findings followed.

DISCUSSION

I. Exclusion of Taxpayer's Subsidiary from Taxpayer's Consolidated Adjusted Gross Income Tax Return.

Taxpayer objects to the exclusion of its out-of-state subsidiary from its consolidated adjusted gross income tax returns. During the tax years at issue, taxpayer engaged in a recapitalization of certain loans entered into by other subsidiaries including a subsidiary operating within Indiana. The recapitalization had the effect of retiring high interest debts and shifting that debt to the out-of-state subsidiary here at issue. The out-of-state subsidiary was able to economically borrow the money necessary to retire the high interest loans because it was in a superior financial position. The out-of-state subsidiary now bears the loan debt – albeit at a lower interest rate – and incurs the expenses concomitant with that loan debt. The audit's decision to exclude the out-of-state subsidiary from the taxpayer's consolidated return, had the effect of precluding taxpayer from taking advantage of the potential tax benefits otherwise attributable to the out-of-state subsidiary.

The audit decided to exclude the out-of-state subsidiary from the taxpayer's adjusted gross income tax returns based upon 45 IAC 3.1-1-111 which states that "The Adjusted Gross Income Tax Act adopts the definition of "affiliated group" contained in Internal Revenue Code section 1504, except that no member of the affiliated group may be included in the Indiana return unless it has adjusted gross income derived from sources within the state . . . ." Therefore, because the audit concluded that the out-of-state subsidiary had no Indiana adjusted gross income, the audit excluded the out-of-state subsidiary.

Taxpayer does not directly challenge the determination that the out-of-state subsidiary did not receive adjusted gross income from sources from within the state. Rather, the taxpayer argues that exclusion of the out-of-state subsidiary results in overstating the income taxpayer – and the consolidated group – received from Indiana sources.

Taxpayer predicates its argument upon the provisions included within IC 6-3-2-2(l) which provides as follows:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable;
>
>> (1) separate accounting;
>> (2) the exclusion of any one (1) or more of the factors;
>> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or

> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In addition, taxpayer cites to IC 6-3-2-2(m) which provides:

> In the case of two (2) or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

IC 6-3-2-2(l) provides the Department discretionary authority to adjust the allocation and apportionment provisions of the adjusted gross income tax in order to arrive at an equitable and accurate allocation of the taxpayer's Indiana income.

The Department's regulation, 45 IAC 3.1-1-62, provides guidance in applying that discretionary authority. In relevant part, the regulation states that "the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states." However, the regulation also cautions "that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results."

Taxpayer argues that before restructuring of its load debt, taxpayer was able to deduct the debt service interest payments from its adjusted gross income because the debt was borne, in part, by taxpayer's in-state subsidiary. The subsequent restructuring did not eliminate the debt but shifted it exclusively to out-of-state subsidiary. However, that restructured debt was intended for the benefit – in part – of in-state subsidiary. The funds made available after the restructuring were used to retire some of in-state subsidiary's debts and fund the continued operation of in-state subsidiary. The funds were used to retire in-state subsidiary's high interest outstanding notes and mortgage bonds which had previously been secured by in-state subsidiary's real property located within Indiana. In addition, the newly available funds were used to retire in-state subsidiary's pollution control bonds issued on behalf of in-state subsidiary. Taxpayer summarizes as follows: "In short, the proceeds from the recapitalization were used to shore up [in-state subsidiary's] balance sheet and capital structure by paying off debt bearing above market interest rates, moving that debt off of [in-state subsidiary's] and onto [out-of-state subsidiary's] books and easing [in-state subsidiary's] burden of managing the debt that remained on its books."

Taxpayer is not entitled to the requested relief because – despite the superficial appeal of taxpayer's argument – the audit's decision to exclude the out-of-state subsidiary from the taxpayer's consolidated return, did not have the effect of artificially distorting the taxpayer's *current* Indiana income. For purposes of determining that Indiana income, the restructuring of the taxpayer’s debt load had the effect of totally eliminating the Indiana debt; therefore, the debt – and the associated interest payments – are entirely irrelevant in calculating taxpayer’s current Indiana income. Although the taxpayer’s debt may be traced to events which were at one time pertinent to taxpayer’s Indiana activities, taxpayer’s voluntary restructuring rendered the current interest payments, immaterial in “effectuat[ing] and equitable allocation and apportionment of the taxpayer’s [current] income.” IC 6-3-2-2(l).

FINDING

Taxpayer’s protest is respectfully denied.

II. Resource Recovery System Credit.

Taxpayer operates a basic oxygen furnace and continuous caster which it classifies as a “resource recovery system” (RRS). Taxpayer’s RRS recycles scrap metals obtained from outside sources, taxpayer’s own scrap metals, and various metallic and non-metallic wastes produced during taxpayer’s manufacturing process. Taxpayer originally claimed a credit for its RRS against receipts subject to the gross income tax equal to the amount of depreciation taken on its federal returns. The audit disallowed the Indiana depreciation credit stating that the deduction was only available under two conditions. According to audit, those conditions were as follows:

> The “waste” which is to be disposed of in a RRS must have been created by the owner of the RRS and the “waste” which is to be disposed of in a RRS must be worthless at the time of its creation by the owner.

Taxpayer argues that these two additional requirements were “invented” and that the additional requirements were “arbitrary and discriminatory.”

Taxpayer claims the credit which is provided for at IC 6-2.1-4-3. The statute states in relevant part as follows:

> If for federal income tax purposes a taxpayer is allowed a depreciation deduction for a particular taxable year with respect to a resource recovery system, and if the resource recovery system processes solid waste or hazardous waste, the taxpayer is entitled to a deduction from his gross income for that same taxable year. IC 6-2.1-4-3(b).

Therefore, in order for taxpayer to claim the credit, the taxpayer must (1) operate a RRS, (2) the taxpayer must have been allowed a federal credit, and (3) the RRS must process “solid waste or hazardous waste.”

The statute sets out the criteria as follows; "'Hazardous waste' has the meaning set forth in IC 13-11-2-99(a) and includes a waste determined to be hazardous waste under IC 13-22-2-3(b)." IC 6-2.1-4-3(a).

IC 13-11-2-99(a) states that the term "hazardous waste" means:

> a solid waste or combination of solid wastes that, because of its quantity, concentration, or physical, chemical, or infectious characteristics, may: (1) cause or significantly contribute to an increase in: (A) mortality; (B) serious irreversible illness; or (C) incapacitating reversible illness; or (2) pose a substantial present or potential hazard to (A) human health; or (B) the environment; when improperly treated, stored, transported, disposed of, or otherwise managed.

In addition, the RRS statute establishes the criteria for "solid waste" stating that "'Solid waste' has the meaning prescribed by IC 13-11-2-205(a) but does not include dead animals or any animal solid or semisolid wastes." IC 6-2.1-4-3(a).

IC 13-11-2-205(a) states in part that "'Solid waste', for purposes of IC 13-19, IC 13-21, IC 13-20-22, and environmental management laws . . . means any garbage, refuse, sludge from a waste treatment plant, sludge from a water supply plant, sludge from an air pollution control facility, or other discarded material, including solid, liquid, semisolid, or contained gaseous material resulting from industrial, commercial, mining, or agricultural operations or from community activities."

Clearly, the Legislature has deemed it appropriate to limit availability of the credit – otherwise available under IC 6-2.1-4-3 – to those RRS which process specifically defined solid or hazardous wastes. Equally clear is that "solid waste or hazardous waste" is defined in such a way as to specifically include certain materials and to exclude certain materials.

IC 13-11-2-99(a) and IC 13-11-2-205(a) support the audit's contention that the depreciation credit is available to those RRS which process materials which are worthless. The statutory authority leads to the conclusion that the Legislature intended to exclude taxpayers from claiming the credit for those RRS which reprocess materials which, by themselves, possess an intrinsic value. However, the statutory authority does not demonstrate that the Legislature intended to exclude taxpayer's from claiming the credit for those RRS merely on the ground that it is processing the valueless waste of third-parties. *See* State of Indiana v. Money, 651 N.E.2d 344 (Ind. Ct. App. 1995).

The taxpayer may not claim the credit for its RRS to the extent that it reprocesses scrap metals obtained from third-parties because these scrap metals possess an intrinsic value. The taxpayer may not claim the credit for its RRS to the extent that it reprocesses scrap metals which are the by-product of the taxpayer's own steel manufacturing activities because those scrap materials also possess an inherent value.

Accordingly, depreciation for the RRS will be eligible as a deduction only to the extent the basic oxygen furnace and continuous caster is used to process the valueless waste of the owner of the RRS or the valueless waste of third-parties. To the extent the RRS is used to process valuable property belonging to the taxpayer or to process valuable property obtained from others, the deduction is not allowed.

FINDING

Taxpayer's protest is respectfully denied.

DK/JM/MR – 020509